No. 78-1767

IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

WILMINGTON TRUST COMPANY,
as successor indenture trustee,
Petitioner,

v.

PENN CENTRAL TRANSPORTATION COMPANY,
Debtor,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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BRIEF IN OPPOSITION FOR PENN CENTRAL TRANSPORTATION COMPANY, Debtor

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June 1979

TABLE OF CONTENTS

TABLE OF AUTHORITIES

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STATEMENT

On October 24, 1978 the reorganization of Penn Central Transportation Company, Debtor, and fifteen secondary debtors, was consummated, thus bringing to an end perhaps the largest and almost certainly the most complex reorganization ever addressed under Section 77 of the Bankruptcy Act. The class of secured creditors, which includes the bondholders for whom peti-

tioner purports to speak, approved the treatment accorded them under the Plan by an overwhelming majority vote (99.4 percent). The bondholders for whom petitioner is trustee themselves accepted the provisions of the plan by a vote of 98.1 percent. Notwithstanding that vote, petitioner has pressed an appeal and two petitions for rehearing to the court below, and failing there has filed its petition in this Court. The petition does not seek to upset the consummation of the reorganization plan; rather, it seeks a more favorable treatment for the particular group of bondholders represented by petitioner—at the expense, of course, of other claimants.

THE PLAN OF REORGANIZATION

To put the position of petitioner into context requires some explanation of the Plan of Reorganization. The characteristics of the Plan are set out in the long and careful opinion of the Reorganization Court (A130-A357),[1] and in a somewhat more abbreviated form in the opinion of Judge Aldisert in the court below (A8-A32).

The objective of the Plan, now accomplished, was to resolve the obstacles presented by an enormously complex set of conflicting and interrelated claims, and the overriding uncertainty as to the value of the Debtors' major asset—the unknown and unknowable amount to be realized in the litigation to determine the value of the rail assets conveyed to Consolidated Rail Corporation (Conrail) and others on April 1, 1976, pursuant to the Regional Rail Reorganization Act of 1973 (45 U.S.C. §§ 701 *et seq.*) (RRR Act).

[1] References throughout are to the Appendix to the Petition for Certiorari.

The Trustees might, of course, have attempted to delay any reorganization until the valuation case had been finally decided—1987 is the target date set in the RRR Act. Or, alternatively, because of the unfairness to claimants of such a delay, they might have opted for liquidation—a course that would have precipitated the massive and time consuming litigation of all the conflicting claims, with the probable end result that even those claimants whose litigation was ultimately successful would not benefit (see A180-A181). The Trustees rejected both of those solutions, and, by compromise resolution of the multitude of conflicting claims, achieved a successful Plan.

The Plan rests on several basic premises. It assumes that the estate is solvent. It bases the on-going operations of the reorganized company—The Penn Central Corporation—on a wholly-owned subsidiary of the Debtor—The Pennsylvania Company—which owns successful non-rail assets and earnings potential. Other assets are to be sold. The proceeds of those sales—Asset Disposition Proceeds, or ADP— together with the recovery in the valuation case, are used to satisfy claimants.

The compromises of the varied issues legitimately in dispute were, of necessity, also essential to the Plan. The first, and basic, one was with the United States, which had guaranteed $100 million of Trustees' Certificates ($50 million were in default), and which, pursuant to Section 211(h) of the RRR Act, had in effect loaned the estate hundreds of millions more. Under the compromise, the defaulted Trustees' Certificates were paid in cash, but the United States agreed to accept for its claims B Notes, some of which are to be paid over

the next several years, but most of which are deferred to the conclusion of the valuation case.

The second, and equally significant, compromise, was with the state and local taxing authorities, whose claims aggregated hundreds of millions of dollars. They agreed to accept 44 percent in cash and notes maturing in two years, and for the balance of their claims notes with maturities related to the target date for conclusion of the valuation case.

In addition, the Plan rests on settlement of potential litigation with the trustee of the New Haven, a major creditor (see *New Haven Inclusion Cases,* 399 U.S. 392); with a group of banks holding in pledge all of the stock of The Pennsylvania Company; with the so-called "Friday Group," representing a large portion of the secured debt; with the active unsecured creditors; with the sole stockholder of the Debtor, The Penn Central Company; and with the trustees and security holders of the 15 controlled leased lines also in reorganization as Secondary Debtors.

One of the most difficult problems, and for purposes of the present petition the most relevant, was the treatment of the complex collection of mortgages, with overlapping and various ranks of liens, vis-a-vis one another. The Trustees reached the conclusion that it was reasonable to treat each of the parent-company mortgages as fully secured, and to treat them as a single class and to accord each a distribution under the Plan of 10 percent of their claim in cash on consummation, new General Mortgage Bonds in principal amount equal to 30 percent of the claim, new Preference Stock with a redemption value equal to 30 percent of their claim, and new Common Stock. Approximately 55 percent of the new Common Stock has been distributed proportionately to secured creditors pursuant to the Plan.

As already noted, a basic premise of the Plan was that, by reason of the anticipated recovery in the valuation case, the Debtor was solvent and all debt was fully secured. It was recognized, however, that security consisting of retained assets could be realized on more quickly than the recovery on property conveyed to Conrail, which would have to await the conclusion of the valuation case. This compromise treatment, therefore, contained in addition a recognition of the fact—albeit a fortuitous one—that some mortgages were secured primarily by property still owned by Penn Central, and some primarily by property transferred to and owned by Conrail. The variations in these circumstances were endless. However, in recognition of the fact that the various mortgages differed in the extent to which their underlying security had been transferred to Conrail, the General Mortgage Bonds, which each secured claimant received for 30 percent of his claim, were divided into two series. Series A Bonds were issued in proportion to the extent the relevant mortgage was secured by assets that had not been so transferred, and Series B Bonds for the balance. The Plan requires that A Bonds be redeemed ahead of B Bonds from the proceeds of the continuing sale of the assets of the estate other than The Pennsylvania Company, and that B Bonds be redeemed ahead of A Bonds from the proceeds of the valuation case.

In approving the Plan, the Reorganization Court made one further adjustment in the interrelationship of the secured creditors. Many of them, including the

present petitioner, urged that any mortgage secured by retained assets in excess of 100 percent of its claim should be given some preference as "super-secured." The court dealt at length with the contention in its opinion (A234-A258)—considering, *inter alia,* alternate distribution schemes; the argument, which he found unsupported, that funds which should go to pay the alleged super-secured would be used to pay mortgages less well secured; and whether, were there a liquidation rather than a plan, the alleged super-secured would or could expert such favorable decisions on their efforts to avoid the consequence of the huge priority claims of the United States and state taxing authorities, as to ensure them a recovery greater than the Plan provided. The court concluded (A257) that in general those mortgage trustees claiming super-secured status received appropriate allocation under the Plan. He further concluded, however, that four mortgages were secured by first liens on retained assets of an amount and quality which rendered them relatively immune from major erosion by administration claims and possible litigation of disputed issues. Two of those mortgages had retained asset coverage of 275 and 243 percent, respectively, and two had retained asset coverage well in excess of 100 percent and were additionally benefited by being secured by an asset less vulnerable to administration claims (A257). For these four mortgages the court directed that, in the 30 percent Preference Stock component of the distribution to them, they be accorded Preference Stock which would have a priority in redemption (Series A), before any other Preference Stock was redeemed (A258). Petitioner's claim to super-secured treatment was rejected.

On appeal to the court below by those claiming super-secured treatment, including petitioner, the analysis and disposition of the issue by the Reorganization Court was affirmed. The court below, however, took cognizance of the fact that one small mortgage of the four mortgages to which the Reorganization Court had accorded Series A Preference Stock (the Mohawk & Malone) was *so* super-secured—not only did it have retained assets equal to 275 percent of its \$1.967 million claim, but its retained assets consisted of \$4.535 million in cash and another \$0.85 million in other retained assets—that it should receive, in lieu of Preference and Common Stock, all A Bonds (A104).

The other change by the court below concerned a different dispute—what could be properly included in the "retained assets" category for the purpose of calculating the A Bond-B Bond allocation to a particular mortgage. The issue was raised by the trustee for the New York Central and Hudson River Railway Company Refunding and Improvement Mortgage (R&I). The trustee of that mortgage, the Bank of New York, had urged, unsuccessfully in the Reorganization Court, that in determining the allocation of A Bonds to that mortgage the Plan should have included as "retained" property the amounts of rents collected from certain New York Park Avenue properties securing that mortgage, which, with the approval of the Reorganization Court (*In re Penn Central Transportation Company* (*Park Avenue Properties*), 484 F.2d (3d Cir.), *certiorari denied,* 414 U.S. 1079 (1973)), were used by the Trustees in the operation of the railroad, and amounts which were not paid by the Trustees, again with the approval of the courts below, in respect of dividends on pledged stock. The court below recognized that such

amounts and the cash otherwise available for the dividends had already been expended, but held that such sums, less any amount that was reinvested in the properties, and less the costs properly associated with the collection of the rentals (A112-A113) should be deemed to be "retained" assets for the purpose of determining the amount of A Bonds to be issued to the holders of R&I bonds. The determination of the net amount, if any, was remanded to the Reorganization Court. The Reorganization Court has not yet determined what that net amount, if any, is.

The relevance of this potential modification of the amount of "retained" assets securing the R&I bonds to the present contention of petitioner requires an explanation of the complex matrix of mortgage liens on the former New York Central and Hudson River Railroad Company (NYC) Properties, of which petitioner's mortgage—the New York Central and Hudson River Railroad Company Michigan Central Collateral Indenture (MC Collateral)—and the R&I mortgage are a part. Three mortgages and two collateral trust indentures together comprise four different levels of liens. At the top is the New York Central and Hudson River Railroad Company Gold Bond, one of the mortgages held to be super-secured. Next are the Lake Shore Collateral Bonds issued under the Lake Shore Collateral Indenture and the bonds represented by petitioner, the Michigan Central Collateral Indenture. Third is the New York Central and Hudson River Consolidation Mortgage, which secures the Lake Shore Collateral and the Michigan Central Collateral bonds, as well as Series A and Series C bonds. The third mortgage, and the fourth level of lien, is the R&I mortgage. All of these mortgages were liens on the Park Avenue properties owned in fee by the Debtor, on the Debtor's leasehold interest in the Park Avenue properties owned by the New York and Harlem Railroad, and in addition were a lien on a substantial part of what was the New York Central railroad system. The Lake Shore stock originally pledged for the Lake Shore Collateral Bonds was extinguished by merger of the Lake Shore into NYC. The Michigan Central Collateral Bonds retained a first lien on 168,143 shares of Michigan Central stock owned by the Debtor. The R&I had a second lien on this stock and a first lien on an additional 17,848 shares of Michigan Central stock and on approximately 95 percent of the stock of the New York and Harlem.

In determining the extent to which the several bond issues in the 013-015 mortgage chain were secured by retained assets for purposes of allocating Series A Bonds, the Reorganization Plan and the Reorganization Court followed conventional marshalling principles. Asset values in excess of those required to provide for a senior claim were marshalled down to the lien next in line, and any surplus after satisfaction of that lien was in turn marshalled down to the next level.

THE DECISION BELOW ON REHEARING

Following the decision of the court below, petitioner and the trustee for the Lake Shore Collateral bonds each filed petitions for rehearing and rehearing *en banc*. The petitions asserted that the decision that the "retained" assets of the R&I mortgage should be deemed to include the Park Avenue rents (the petition asserted by $60 million, although the net amount is still undetermined) should result in an increase in the value of the "retained" assets subject to their senior mortgages on the same properties, and that therefore they

were entitled to "super-secured" status or better. The petition was denied in a brief opinion (A124-A126), on the ground that the claims were made for the first time in the petitions for rehearing (A127-A128). A second petition for rehearing filed by petitioner, asserting that the court was in error in denying the first petition for rehearing on the ground that the claims had not been made earlier, was denied without opinion (A129).

REASONS FOR DENYING THE WRIT

I

Petitioner does not deny that, if the court below was correct in concluding that the contentions made in its petition for rehearing had not been raised earlier, that is an end to the matter. The trustee of the Lake Shore Collateral bonds (the Manufacturers National Bank of Detroit, which stands *pari passu* with petitioner insofar as its relationship to the R&I mortgage is concerned, conceded that it had not raised the issue presented in the petition for rehearing prior to its rehearing petition (Pet. p. 12). Petitioner's attempt to show that it had done so is without substance, and certainly does not rise to the level calling for the extraordinary assertion of this Court's power of supervision over the Courts of Appeal pursuant to Rule 19(1)(b).

Petitioner relies in support of its contention that it objected to the diversion of the Park Avenue rentals on three brief excerpts culled from a 61-page brief and a 35-page reply brief. The sole excerpt from its brief, which is taken from the Statement of the case, not from the argument, simply asserts that the Park Avenue properties are valuable. The longer excerpt from the reply brief argues a wholly different point—that

the Park Avenue properties should be immune, in a liquidation, from administration claims. The shorter reply brief excerpt criticizes the Trustees' analysis of values on a hypothetical basis, and certainly does not articulate an argument for increasing the amount credited to its underlying security by the net amount of the Park Avenue rentals. Even these isolated excerpts in almost 100 pages of briefs, while they *refer* to the rentals from the Park Avenue properties, do not in any way argue that the proper definition of "retained" properties should include the net amount of such rentals—the argument which was successfully asserted in the court below, and had been asserted in the Reorganization Court, by the trustee of the R&I mortgage in relation to the allocation of A Bonds. Indeed, in response to the argument by the trustee of the R&I mortgage, the Penn Central Trustees' brief to the court below noted, in a footnote on page 74:

> "Although they hold prior liens, neither the trustees nor any bondholders under the Gold Bonds and the Consolidated Mortgage make a claim to the rental income from the Park Avenue properties as a retained asset."

The Consolidated Mortgage, as stated above (p. 8), secures petitioner's bond issue. Petitioner later filed a 35-page reply brief, which was described (p. 1) as a "reply specifically to the brief of the Trustees [of Penn Central]," and did not challenge the statement in the footnote.

Petitioner makes much of its argument that the court below urged parties to avoid duplicate arguments, and that the "laboring oar on the rentals" was carried by the trustee for the R&I mortgage and for the Harlem dividends by the trustee for the Consolidated

Mortgage (Pet. p. 9). Yet, as the Court of Appeals noted (A125), neither the excerpts quoted in the petition, nor any other portion of the brief or reply brief filed by petitioner in the court below contains any cross-reference to such arguments made by other parties, nor any suggestion that such arguments of others were being adopted by reference, although petitioner expressly adopted by reference an argument of the Detroit Bank on a wholly different issue (Reply Brief, p. 27).

What seems apparent is that petitioner, following the initial decision of the court below, recognized that the decision might provide a new opportunity to secure, as it now asks (Pet. p. 18) treatment as "super-secured," and that its general references to the rentals and dividends in the course of arguing the benefit to the estate from the use of Park Avenue rentals, or challenging the marshalling of assets which was approved by both courts below in determining super-secured status, might supply a basis for its contention. Those general references, however, never came close to specifying the contention that petitioner advanced in its petition for rehearing.

The court below, as its several opinions reveal, was thoroughly familiar with both the record and the varieties of arguments that were advanced. Its conclusion that petitioner's new argument came too late was correct.

II

In any event, the claim for preferred teatment of the MC Collateral bondholders asserted in petitioner's request for rehearing is without merit.

As noted above, the analysis of the security underlying each mortgage was not made to determine whether the mortgage was fully secured—that was assumed—but solely for the limited purpose of determining the A Bond-B Bond allocation of the General Mortgage Bond component of the securities distributed to secured creditors. In making this analysis the Trustees, the Securities and Exchange Commission (which was asked by the Reorganization Court to review the Plan) and the Reorganization Court itself considered all retained assets, allocated them under established principles of marshalling, and made the allocations accordingly. The MC Collateral Bonds were, on that analysis, fully secured by retained assets, and hence received A Bonds exclusively. The decision of the court below to give the R&I Mortgage credit for the net of Park Avenue rentals and Harlem dividends, thereby increasing the proportion of A Bonds which the R&I bondholders received, thus could have no effect on the A Bond allocation to bonds represented by petitioner.

The issue which petitioner sought, for the first time in its petition for rehearing, to raise by reason of this change in the R&I Bond component is quite different —whether the MC Collateral Bonds should be included in the "super-secured" category. Only four bond issues met the standards established by the Reorganization Court and approved by the court below for that limited category: either first liens on retained assets valued at substantially more than twice the debt secured, or first liens on marketable securities—stock of the Pittsburgh & Lake Erie Railroad Company, a profitable railroad not part of the Debtor's system—with a market value in excess of the debt secured. Recognition of the former rested on the ample margin

of safety afforded by the excess value against potential erosion by administrative claims in a liquidation context. Recognition of the latter rested on the relatively lower exposure of the Pittsburgh & Lake Erie stock to such claims. The court below found the standards sound (A55-A56; A76-A77).

Nothing in the decision of the court below permits the MC Collateral Bonds to qualify under those standards. Unlike the Pittsburgh & Lake Erie stock, the Michigan Central Railroad stock on which they had their only first lien was an interest in a railroad which is an integral part of the Penn Central system and which was a Secondary Debtor, and can lay no claim to relatively low exposure to administration claims in a hypothetical liquidation. Indeed, the value of $25,195,000 attributed to the stock for Plan purposes is subject not only to erosion by administration claims, but also, in a hypothetical liquidation, to a priority claim of approximately $100 million (A261) by the Penn Central Trustees against the Michigan Central—a claim compromised out under the Plan—which would reduce to zero value the only property on which the MC Collateral Bonds had a first lien.

Moreover, petitioner conveniently ignores that part of the opinion of the court below which adversely affects the value of its collateral. Its petition (p. 5) ascribes a value of $48.2 million to "certain property subject to the Harlem lease." The decision below has a substantial impact on that figure, which was hotly disputed in the Reorganization Court. The correct amount depends on an allocation of values between the leasehold interest of the lessee and the fee interest of the lessor. The Reorganization Court found it unnecessary to resolve this issue in the context of General

Mortgage Bond allocation, since what was added to the security for senior liens would simply flow down to the R&I mortgage as the more junior lien (see A270-A-271). However, the Court of Appeals holding that the R&I trustee, as pledgee of the Harlem stock, is entitled to credit for $7.1 million of dividend rentals accrued during the seven and one-half years of reorganization, almost $950,000 a year, indicates a reduction in value of the leasehold not only by the $7.1 million credit but by the present value of the additional rental payments during the term of the lease. Possible additional reductions are noted in the Reorganization Court's opinion (A272).

Essentially, petitioner seeks to meld two entirely separate concepts used by the courts below—one dealing with the proper allocation of A Bonds, and the other with super-secured status. That the court below gave credit in allocating A Bonds to an intangible—Park Avenue rentals which had long since been used in the continuing operation of the estate—by deeming them to be a "retained asset" had no relevance to a wholly separate matter—whether a bond issue was super-secured. The two concepts had different standards and different purposes. They do not meld.

CONCLUSION

The issues raised by the petition for certiorari are unique to the Penn Central Plan of Reorganization, which itself is unique in the annals of now-repealed Section 77 of the Bankruptcy Act (P.L. 95-598, Nov. 6, 1978) and cannot on any basis be considered as of general importance. The court below correctly declined to consider what it found to be a new issue raised by petitioner for the first time on rehearing, and in any event the issue lacked merit. The petition for certiorari should be denied.

Respectfully submitted,

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